

Dear Chair Barnett and Esteemed Committee Members:

We appreciate the State Intercompany Transaction Service (SITAS) Committee's work on the revised information sharing agreement. As we have discussed with representatives from many of the Committee's member states, we believe that using federal transfer pricing principles is often the most appropriate method to allocate income among related entities. Initiatives that further certainty with respect to transfer pricing, like advance pricing agreements and settlement initiatives, are also most welcome. We write today, however, to express concern with the SITAS Committee's approach to information sharing among its member states and their third party contractors hired to assist with transfer pricing audits.

#### Proposed Information Sharing Agreement

During its July 13, 2021, meeting, the SITAS Committee discussed a "revised" State Intercompany Transactions Advisory Service Committee Participation Commitment and Exchange of Information Agreement (Agreement).<sup>1</sup> The Agreement is expected to be executed by participating states to facilitate sharing taxpayer information. The SITAS Committee also approved a draft charter that *requires* participating states to sign the Agreement.

While we appreciate the SITAS Committee's efforts to memorialize limitations on information sharing, we are concerned that the Agreement does not sufficiently protect taxpayers' confidential information and could potentially subject revenue officials and their contractors to penalties under state law. Indeed, most states' laws prohibit and impose criminal and sometimes civil liability for disclosing taxpayer confidential information outside the formalities of state anti-disclosure statutes.<sup>2</sup>

Taxpayer specific information is generally afforded the highest degree of confidentiality under most states' laws. We have, however, recently become aware of instances where states have disclosed such information to other states or third parties outside of formal information sharing protocols.

Although the Agreement provides that it "is not intended to expand or contract any other state law or agreement pertaining to the exchange of confidential taxpayer information,"<sup>3</sup> it contains few substantive safeguards designed to secure taxpayer confidential information. Indeed, Article IV of the Agreement sets forth a laundry list of information that could be shared, placing the onus upon each individual signatory state to determine whether such disclosure runs afoul of state law.<sup>4</sup> The lack of clear guidance is not only concerning to taxpayers, but also it

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<sup>1</sup> See <https://www.mtc.gov/getattachment/The-Commission/Committees/SITAS/SITAS-Agenda-7-2021/SITAS-Agreement-2021-Proposed-Update-FINAL.pdf.aspx>.

<sup>2</sup> *E.g.*, Ala. Code § 40-2A-10(a) (classifying each act of unlawful disclosure as a Class A misdemeanor); Miss. Code Ann. § 27-7-87(3) (imposing criminal liability, punishing same by minimum fine of no more than \$1,000, imprisonment of no more than one year, or both; dismissing officers and employees of the state from office and prohibiting same from holding any public office in the state for a period of five years); N.C. Gen. Stat. § 105-259(c) (imposing criminal liability as a Class 1 misdemeanor for violations of anti-disclosure law; dismissing officers or employees from public office or employment and prohibiting same from holding the public office or employment for a period of five years after the violation); S.C. Code Ann. § 12-54-240(A) (imposing civil and criminal penalties on violations of anti-disclosure law, classifying such violations as a misdemeanor subject to punishment by a fine of no more than \$1,000, imprisonment for no more than one year, or both; dismissing public officers and employees from office and disqualifying same from holding public office for a period of five years; and penalizing contractors who violate anti-disclosure laws by immediately terminating the contract and disqualifying such company from eligibility to contract with the state for a period of five years).

<sup>3</sup> State Intercompany Transactions Advisory Service Committee Participation Commitment and Exchange of Information Agreement, Article III.

<sup>4</sup> See State Intercompany Transactions Advisory Service Committee Participation Commitment and Exchange of Information Agreement, Article IV.

should be concerning to participating states. For example, a participating member could unknowingly share information that would run afoul of another state's law—putting the group's work in murky legal territory.

We are also concerned with the provisions in the Agreement permitting information sharing with agents of signatory agencies (who are not a party to the Agreement). While some states' laws permit sharing information with third parties in limited circumstances, others do not. Moreover, to the extent information is shared with third parties, the Agreement does not adequately limit third parties' use of information to the particular audit for which the information is shared. Given their financial incentives, state contractors may attempt to use information obtained in one audit to further their ends in another state's unrelated audit. While we appreciate that contractors may wish to leverage their experience from one state to another, this type of "leverage" may run afoul of states confidentiality laws. Additionally, contractors should not be permitted to save or catalog taxpayer data for use on future audits.

We would also note that third party auditors' interests are not entirely aligned with state tax enforcement agencies, and therefore, sharing information with these contractors raises additional concerns. As the Council on State Taxation (COST) has observed, contingent fee contracts, while perhaps authorized by state law, still undermine equitable, effective, and efficient tax administration.<sup>5</sup> In the context of information sharing under the Agreement, our concerns regarding third party contractors paid on a contingent fee basis are heightened. The prospect that a third party fee-contingent contractor will misuse confidential information is elevated because the contractor is incentivized to do so. These are not just abstract concerns – there is evidence that third party auditors are not bound by the same ethics as state tax enforcement agencies. For example, in a recent Delaware Supreme Court case, the court upheld the denial of an administrative subpoena where the lower court suspected the third party auditor would misuse the subpoenaed information (i.e., for a another state audit).<sup>6</sup> And just a month ago, a large third party auditor, with whom many would-be signatory states have contracted, may have exposed taxpayer confidential information in the popular tax press to advertise its services for conducting transfer pricing audits.<sup>7</sup> If not a direct violation of state anti-disclosure laws, this certainly seems a violation of their spirit.

Furthermore, not all state anti-disclosure laws are written the same. Alabama's state anti-disclosure law and administrative code, for example, disfavors sharing information with another tax agency's third party auditors.<sup>8</sup> Indeed, because taxpayer information is highly sensitive, most states' laws prescribe a strict processes that must be followed prior to authorizing release of confidential taxpayer information. When information is shared between tax agencies, the process generally requires a written request from the party seeking taxpayer information and a written authorization from an official having custody over such information.<sup>9</sup> The proposed draft Agreement fails to expressly take these procedures into account, although it may be within the parties' intentions to do so.

Sharing the content of settlement agreements and advanced pricing agreements – a practice we have also observed in recent history – is also troublesome. Generally, the sharing of such information is likely to have the opposite effect of that which is intended. As recently expressed by a member state during the MTC's Annual Conference, sharing this information could start a race to the bottom. Moreover, the practice has a chilling effect on taxpayers' appetites to enter into such agreements.

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<sup>5</sup> Comment Letter, Council on State Taxation, Re: COST's Opposition to Georgia Senate Bill 480 (March 5, 2020) ("Contingent-fee arrangements jeopardize the neutral and objective weighing of the public's interest, and instead create a direct economic interest for the third party in the outcome of the services rendered.").

<sup>6</sup> *Dep't of Finance v. AT&T Inc.*, No. 303, 2020 (Del. June 1, 2021).

<sup>7</sup> See Tax Notes, Cook and Cook, "2.7 Billion 2018 Northeastern State Transfer Pricing Tax Gap".

<sup>8</sup> See Ala. Admin. Code r. 810-14-1-.29(2)(e) (excluding tax agency contractors from definition of authorized persons with whom information may be shared directly).

<sup>9</sup> See, e.g., Miss. Code Ann. § 27-7-83(2).

The recent success in Indiana bears this out. Indiana's advance pricing program, which serves the same policy objectives that the states hope to accomplish by entering into the Agreement, has seen success in large part because the program requires complete confidentiality. Information cannot be shared with any other states by the very terms of the program agreements.<sup>10</sup> The success of this program is an example of a policy that empowers a taxpayer and a state to engage in a productive conversation – made possible only because taxpayer information remains confidential.

#### Recommendations for Improving the Agreement

We hope that those considering entering into the Agreement bear in mind the foregoing concerns. Furthermore, considering these concerns, we offer the Executive and SITAS Committees five recommendations for strengthening taxpayer confidentiality while balancing the member states' ability to conduct fair and timely audits:

1. The SITAS Committee should consider adopting "written authorization" procedures as a matter of maintaining accountability and protecting taxpayers from fishing expeditions by third party auditors. Specifically, when information is requested pursuant to the Agreement, the request should be made in writing, should identify the person seeking the information and with whom the information could be shared. The request should also set forth the particular information requested, the dates for which such information is required, and the purpose for the request.
2. Information sharing should be used solely for the requesting state's transfer pricing audit.
3. State administrators should discourage fishing expeditions by third party auditors. The Agreement should provide that requests must be relevant to a specific audit and set forth the audits in which the information will be used. The Agreement should expressly provide that the information exchanged will not be used for other commercial purposes, whether or not taxpayer-identifying information is redacted.
4. Third party auditors should be required to sign an acknowledgment of the Agreement, in which they agree to abide by each state's specific statutory provisions regarding the prohibition against the sharing of confidential taxpayer information. While we strongly oppose sharing of information with third party auditors, we recognize that as a practical matter many states already engage with such contractors. Accordingly, we would recommend that any such contractor sign an Agreement acknowledging the civil and criminal liability associated with information sharing and agree to abide by those specific state laws.
5. States should be required to notify a taxpayer whose information has been shared pursuant to the Agreement. We note that several states require practitioners to notify the agency when their taxpayer information has been breached, and we favor a similar disclosure requirement with respect to state agencies. Thus, it would seem fair to ask a state that discloses information being shared pursuant to the Agreement to do the same.

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<sup>10</sup> See Bloomberg Tax, Bologna, "Indiana Commits to Confidentiality in Advance Pricing Agreements."

Again, we appreciate the Executive and SITAS Committees' attention to this matter and the opportunity to engage in open dialogue concerning such sensitive, yet important matters as sharing taxpayer confidential information. We look forward to continued conversations on these issues with the Committees.

Sincerely,

A handwritten signature in black ink, appearing to be "E. Tuck", written in a cursive style.

Eversheds Sutherland (US) LLP